Appendix A

Issues paper on fair dividend rate method

The Government has proposed a fair dividend rate method for taxing offshore portfolio share investments. This new proposal would broadly replace the main offshore tax proposals currently in the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill 2006.

How the fair dividend rate method would work generally

Under the fair dividend rate method, 5 percent of the market value of offshore shares held at the start of a tax year (that is, 1 April) would be taxable. The key features of the fair dividend rate proposal are:

- It would apply only to portfolio investments in offshore shares (that is an interest of less than 10 percent in a foreign company) that have verifiable market values.
- It would work on a pooled approach, rather than on an investment-by-investment approach for assets that qualify (it would not apply to those assets for which a different income calculation method is used).
- Purchases and sales of shares during a year would be ignored (except where the shares are bought and sold in the same year).
- Dividends would not be taxed separately. (Foreign withholding tax deducted from dividends would still be available as a foreign tax credit under section LC 1(1) and (4) of the Income Tax Act 2004.)

Application of the fair dividend rate method to individuals and family trust investors

For individual investors and family trusts (that is, trusts that meet the criteria outlined in proposed section EX 44C in the bill), a variation to the standard fair dividend rate approach outlined above would be allowed. Under this variation if investors can show that their total return on all their offshore shares, for which the fair dividend rate method is used, is less than 5 percent of the opening market value they would be taxable on the actual return. If the total return for the year is negative (that is, a loss is made), no tax would be payable. The total return would be calculated using the following formula:

(closing market value of shares held + total sales proceeds + dividends received) – (opening market value of shares held + total value of purchases)

The following example illustrates how the variation to the fair dividend rate method would work.

Example 1

Bob holds offshore shares worth $100,000 on 1 April 2007. On 20 June he buys another $20,000 of offshore shares, which he holds until the end of the year. He receives a dividend of $3,000 on 1 October. His shares are worth $121,000 at the end of the year.

In this example, Bob would be taxable on $5,000 (that is, 5 percent of $100,000) under the standard fair dividend rate method. However, he could be taxable on a lesser amount if he is able to show that his actual return is less than $5,000. Bob calculates that his actual return is ($121,000 + $0 + $3,000) – ($100,000 + $20,000) = $4,000

As Bob's total return is less than 5 percent of his opening value, he would be taxable on the lower amount of $4,000.

Application of the fair dividend rate method to managed funds and other non-natural person investors

For New Zealand managed funds (including portfolio investment entities) and non-natural persons other than family trusts, the standard fair dividend rate method would only apply. This would mean that tax would be payable on a fixed 5 percent return irrespective of how investments perform. For most managed funds, the 5 percent fair dividend rate would apply to the average value of the entity's offshore portfolio share investments for the year.

A fixed fair dividend rate is proposed for offshore share investments held by managed funds as this would be simpler for funds to apply than a variable fair dividend rate, particularly under the portfolio investment entity tax rules (which are also contained in the bill).

The Government has indicated that it considers that, overall, investors in managed funds should not be significantly disadvantaged (under a fixed 5 percent fair dividend rate method) compared to those investing directly in offshore shares (who could face a lower effective fair dividend rate as no tax would be payable when losses are made). The Government considers that one of the reasons for this is that investors in New Zealand managed funds would receive a number of benefits that are not available to individual direct investors, under the portfolio investment entity tax rules and KiwiSaver. The benefits of the portfolio investment entity tax rules include:

- having the tax rate on portfolio investment entity income capped at 33 percent (versus 39 percent for direct investors)
- portfolio investment entity income not counting towards family assistance entitlements under Working for Families or affecting student loan repayment or child support payment obligations
- investors in portfolio investment entities receiving Australasian share gains free of tax, whereas individual share traders would continue to be taxable on these gains.

The Government has indicated that the total value of the tax changes for managed funds in the bill (as measured in terms of the revenue cost of the portfolio investment entity tax rules) is in excess of $100 million per annum.

The Government also considers that investors in KiwiSaver funds will receive a significant benefit from not having their employer contributions subject to tax.

Application of the standard fair dividend rate method to managed funds

For investment vehicles, such as unit trusts and superannuation funds, that calculate the value of their investments on a regular basis, it is proposed that taxable income for each valuation period would be calculated using the following formula:

5 percent x market value of investments at start of period x the number of days in the period divided by the number of days in the income year.

The valuation period for an entity could range from a day (for unit trusts that price daily) to a quarter. Where the valuation period is one day, an entity would not have to apply the rules proposed for shares bought and sold in the same income year (see below) as income would be calculated daily. Where the period is greater than a day (for example, a month or a quarter), the entity would need to apply the rules proposed below, for shares that are bought and sold during the valuation period.

Shares bought and sold in the same income year

It is proposed that shares that are purchased after the start of the income year and then sold before the end of the same income year (that is, within a 12-month period) would be taxed on 5 percent of the cost of the purchase. Without such a rule, no tax would be payable on these shares as they would not be reflected in the value of shares held at the start of the year and would also not be reflected in the value of shares held at the start of the following year.

To take account of shares bought and sold in the same tax year, the standard fair dividend rate method would apply as follows:

Taxable income = 5 percent x (the opening market value of offshore portfolio share investments held at the start of the year + the average cost of any purchases made during the year that are sold before the end of the year)

Investors would need to apply the so-called last-in-first-out (LIFO) method to determine whether the shares sold were purchased in the same year.

Example 2

Jane holds 10,000 offshore shares worth $50,000 in A Co and 10,000 shares worth $30,000 in B Co on 1 April 2007. On 15 October, she buys another 5,000 shares in B Co for $20,000. She receives a dividend of $2,000 from A Co and $500 from B Co. On 2 February 2008, Jane sells 3,000 of her B Co shares for $15,000. At the end of the year, Jane's 10,000 A Co shares are worth $55,000 and her remaining 12,000 B Co shares are worth $45,000

In this example, Jane would be taxable on $4,000 (that is, 5 percent of $80,000) under the standard fair dividend rate method. However, Jane also bought 3,000 shares in B Co (at a cost of $4 each) during the year that she sold before the end of the year. Therefore, the standard method is adjusted such that her taxable income would be 5 percent of ($80,000

+ $12,000). This is $4,600. Jane could be taxable on a lesser amount if she is able to show that her actual return is less than this. Jane calculates that her actual return is:

($100,000 + $15,000 + $2,500) – ($80,000 + $20,000) = $17,500

As Jane's total return is more than $4,600, she would be taxable on $4,600.

Offshore investments to which the fair dividend rate method would not apply

The fair dividend rate method would not apply to investments in foreign companies that provide a so-called 'guaranteed return' to investors. Applying the fair dividend rate method in such instances could allow New Zealanders to invest in offshore companies that invest in, for example, high-yield debt (which if invested into directly would be taxed on the full return) and be taxed on a maximum 5 percent return.

Offshore portfolio investments which do not qualify for the fair dividend rate method would broadly be defined as those which have an effectively non-contingent obligation, directly or through an arrangement, to return an amount to the investor that exceeds the issue price of the investment. Contingencies that are immaterially remote would be ignored for the purposes of this rule. The concept is based on the Australian 'economic substance' test for determining whether an instrument is debt or equity, and the guidelines issued by the Australian Tax Office would be useful in understanding what an 'immaterially remote contingency' is. Investments that do not qualify for the fair dividend rate method would be taxed under the comparative value method in the foreign investment fund rules.

It is also proposed that the Commissioner of Inland Revenue will be able to issue a determination that an investment that:

- did not meet the definition outlined above, but was still substantially debt in nature, would be treated as a non-qualifying investment and therefore subject to taxation under the comparative value method
- met the definition but was not substantially debt in nature would not be treated as a non-qualifying investment and therefore remain subject to the fair dividend rate method.

This determination process should provide sufficient flexibility to deal with cases close to the boundary.

In addition, investments in foreign companies in the form of fixed-rate shares (as defined in section LF 2(3) of the Income Tax Act 2004) and non-participating redeemable shares (as defined in section CD 14(9)) would specifically not qualify for the fair dividend rate method.

Exemptions from the new offshore tax rules

The Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill contains a number of exemptions from the offshore tax proposals, as introduced:

- offshore investments outside Australia, costing NZD$50,000 or less, that are held by individuals
- investments in Australian resident listed companies;
- investments in certain foreign companies (such as Guinness Peat Group) for a period of five years
- investments in New Zealand start-up companies that migrate offshore to gain access to finance (that is, venture capital type investments).

Offshore investments with no market values

For offshore share investments which do not have a verifiable market value (for example, because the company is not listed on a recognised stock exchange), it is proposed that a cost-based variant of the fair dividend rate method would apply. Investors would only be able to use this option if it is not reasonably practicable to obtain a market value.

Under this cost-based variant, an investment would be taxable on 5 percent of the cost of the investment, with the cost base increased by 5 percent each year to proxy for an increase in the value of the company. As the deemed 5 percent growth per year is likely, on average, to underestimate the actual increase in the value of the investment it is proposed that any dividend received should not be subtracted from the cost base. This would also simplify the mechanics of this rule.

The cost-based variant of the fair dividend rate method would also apply to interests in foreign superannuation schemes and life insurance policies for which market values are not available (note that foreign superannuation schemes and foreign life insurance policies that are currently exempt from the foreign investment fund rules would continue to be exempt).

Example 3

On 1 April 2007, Peter holds an interest in a family company that is resident in the United Kingdom. He put in capital of $20,000 for which he received an 8 percent shareholding. The value of his holding is not able to be independently verified. Therefore, Peter would need to apply the cost-based variant of the fair dividend rate method. Under this method, his taxable income for the 2007-08 year would be calculated as 5 percent of $20,000 = $1,000. In the 2008-09 year, his cost base is deemed to have increased by 5 percent (that is, by $1,000). His taxable income in the 2008-09 tax year would therefore be 5 percent of $21,000 = $1,050. His taxable income in the 2009-10 year would be 5 percent of $22,050 = $1,102.

Other foreign investment fund calculation methods

It is proposed that the fair dividend rate method would replace the market value and smoothed market value methods currently in the bill for offshore portfolio equity investments. The cost-based variant of the fair dividend rate method would replace the cost method currently in the bill. Investors would, however, still have the option of applying the branch equivalent and accounting profits methods to calculate income from foreign investment fund interests, if they satisfy the conditions for applying these methods.

Application date of the new offshore tax rules

It is proposed that managed funds would be able to elect to apply the current tax rules, instead of the fair dividend rate method, until 1 October 2007 (the proposed application date of the portfolio investment entity tax rules). This should ensure that managed funds are able to transition into the new tax rules from a single date.

It is proposed that the fair dividend rate method would apply from 1 April 2007 for individuals, family trusts, and other non-managed fund investors holding offshore portfolio share investments.

A deemed rate of return proposal

The committee has received a proposal for a deemed rate of return from PricewaterhouseCoopers that would tax the higher of dividends received or 3 percent of the average market value of offshore shares held during a year. The average market value would be calculated as the average of the opening (1 April) and closing (31 March) market values. Part-year adjustments would be required where shares are bought and sold during a year (although calculation of the deemed rate of return on a total portfolio basis without the need to recognise trades in a year has been suggested as an alternative). It is the committee's understanding that this method would apply to both individual and non-individual person investors (such as managed funds).

The Government has indicated that it prefers the fair dividend rate method as it considers that a fair dividend rate would:

- not tax individual investors when they make a loss (whereas a fixed deemed rate of return would tax a return of 3 percent, or dividends if higher, in loss years)
- would be simpler to apply than a deemed rate of return, as it does not separately tax dividends, does not require the average of opening and closing market values to be calculated and it does not require part-year adjustments when shares are bought and sold.